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STATE PLEASE PASS TO USAID, USTR, EXIM, OPIC, USED IDB, USED WB, USED IMF

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TAGS: EFIN ECON EAID EINV ETRD PGOV SENV HO
SUBJECT: Honduras Asks for Help on Paris Club and HIPC

¶1. (U) Summary and Action Request. The Honduran government has requested support of the USG (and other donors) to extend to June 2003 in its Paris Club debt service deferral and changes in the methodology used for HIPC and Paris Club debt relief and funding of the GOH's Poverty Reduction Strategy. Washington agencies are requested to provide guidance for a response. End Summary and Action Request.

¶2. (U) In an August 5 letter signed by the Minister of the Presidency, the Minister of Finance and the President of the Central Bank, the Honduran government updated the international donor community Ambassadors on the actions taken by the Maduro administration to date to improve government finances and meet conditionality of its Poverty Reduction and Growth Facility program with the IMF. In the letter, the Ministers indicated that after analyzing the implications of the deterioration in government finances in 2001 and the miscalculations in the Flores government's 2002 budget, the GOH took a number of steps designed to improve tax collection, reduce public spending and make the government more efficient. In the letter, the GOH emphasizes that it will continue to work towards fiscal responsibility and seeks to negotiate a new three-year agreement with the IMF in October.

¶3. (SBU) The letter included an attachment outlining some of the difficulties the GOH has encountered in meeting the obligations in its Poverty Reduction Strategy Paper (PRS) and the HIPC debt relief requirements. The attachment ends with an appeal to the donor countries to support the GOH's requests for Paris Club debt service deferral through June 2003, for lowering the amount of debt relief assigned to pay for poverty reduction projects, and for its efforts to reach an agreement with the IMF on a new three-year PRGF program by the end of 2002. An informal translation of the letter is provided in para 5. An informal translation of the lengthy attachment on the Poverty Reduction Strategy is provided in para 5.

¶4. (U) Begin informal translation of August 5 letter.

Dear Ambassador Almaguer,

The purpose of the following letter is to make you aware of the actions that the Government of Honduras, under the Maduro administration, has taken during 2002 to stabilize Honduras' medium-term macroeconomic outlook in light of serious public finance problems.

As the IMF confirmed during its visit in May 2002, public finances significantly deteriorated in 2001 leading to Honduras' non-fulfillment in December 2001 of the macroeconomic targets that had been agreed by the IMF and the previous Honduran government. The central government deficit was six percent of GDP in 2001, while the consolidated public sector debt was three percent. These deviations resulted in an unexpected situation for the new government, especially since the close relationship between the IMF and the previous government until the end of 2001 had raised expectations that Honduras' fiscal situation was within the norms established under the IMF agreement. This situation severely limited our capacity to act over the last year.

To complicate matters, the previous government's budget for 2002, which was approved by the National Congress in December 2001, did not include important spending obligations and overestimated projected income for 2002 by about 1.5 percent of GDP. Our belief that there were miscalculations was confirmed by the marked difference between actual and projected tax collections.

Conscious that this situation was totally unsustainable and with the intention of orienting the country towards a medium and long-term vision of fiscal stability, the Honduran government implemented and is in the process of implementing

a number of corrective measures, including:

-- Issuing Executive Decree PCM-005-2002 which contains a series of austerity measures to reduce public spending and save the government an approximately usd 12.3 million in spending.

-- Passage in Congress of the Financial Stabilization Law which expands the tax base, reduces tax exemptions, contemplates sanctions for tax evasion (including the temporary closure of business), reduces import taxes to discourage contraband, harmonizes tariffs with the rest of the region and simplifies payment procedures for tax payers. Unfortunately, prolonged development of the law and discussion in the National Congress caused its implementation to be delayed until July, thus delaying improvement in tax receipts before then.

-- After a long and difficult negotiation, the Honduran government agreed to phase-in increases, over a four-year period, in public school teacher salaries that were due in ¶2002. Beginning in 2006, new salary increases will be granted based on increases in the minimum wage. This agreement will help reduce steep annual salary increases for public school teachers and will allow the discussion of teacher's salaries to be included in the government's unified salary policy in 2006.

-- In July 2002, Honduran authorities began closing businesses (note: temporarily) that were not paying sales tax. This is the first time that businesses have been closed for sales tax evasion and we hope this measure will help instill a culture of honoring tax commitments in Honduras.

-- In the second half of 2002, the Honduran government will begin implementing new administrative procedures to improve tax collection. We will also conduct a study to re-engineer the public sector. The results of the study will allow for greater efficiency and quality of service in the public sector and at the same time reduce its size.

-- We will soon submit to the National Congress a modern and equitable Income Tax Law that will complement the expansion of the tax base and the administrative simplification process. We will also review the Tax Code.

-- The Ministry of Finance presented to the National Congress for consideration a report on budget performance for 2001 and the first six months of 2002. The revised budget was also published in the two Honduran daily newspapers with the highest circulation.

-- A new budget formulation policy was designed for 2003, consistent with the IMF's budget transparency code, which will eliminate global expenditures (note: large budget line items which previously were left to the discretion of the Honduran president to assign to different ministries).

-- By December 2002, a comprehensive, coherent and consistent civil service reform law will be submitted to the National Congress.

To complement the government's fiscal measures, the government has made progress in other important areas to create an environment that encourages economic growth, including:

-- The Honduran government has improved its institutional framework by proposing to create the Supreme Accounts Tribunal, instituting a new selection process for Supreme Court Justices, implementing the new Criminal Procedures Code, making government procurement more efficient and transparent, transferring management of government procurement to organizations like the United Nations Development Program and the World Food Program, who are improving prices and reducing the potential for corruption, and working with the Anti-Corruption Commission.

-- With the help of the World Bank and the IDB, the government is committed to increasing private sector participation in public services and infrastructure projects and has begun the public bid process for a new cellular system contract, selected port services, national mail service and electricity distribution.

-- The Poverty Reduction Fund Law was approved and legislative reforms to strengthen the financial system are close to being approved in the National Congress.

-- The Central Bank of Honduras has instituted open market operations to orient the market towards an interest rate more consistent with the decreasing inflation rates experienced in recent years and obtain monetary base growth rate in line with the expectations of GDP growth for 2002.

-- The recently approved Monetary Program for 2002 includes measures to eliminate during July and September the obligatory investments in government securities by financial institutions, equivalent to three percentage points of local currency obligations, and update the minimum capital requirements for financial institutions. In conformity with the Monetary Transparency Code, an external audit of Central Bank operations was completed for the first time.

-- Reforms to the Insurance Deposit Law have been introduced to the National Congress and immediate actions were taken to confront two longstanding bank insolvency problems. Assets and deposits were also transferred from one problematic bank to a stable institution. Technical assistance has been solicited from the World Bank to help the Deposit Insurance Institution value the two intervened banks and formulate a strategy for their sale over the next year. In the short-term, the IMF and the World Bank will assist in an analysis of the financial system that will serve as the basis for further consolidation of the financial sector.

-- Implementing regulations for the Securities Market Law have been issued to improve the functioning of Honduras' securities markets. Technical assistance has been contracted with IDB funds to issue implementing regulations for the Insurance Law. The Private Pension Fund Law will be discussed soon in the National Congress.

-- A program will begin in September with IDB funds to improve the technical capacity of bank auditors in the National Banking and Insurance Commission. Basic and advanced CAMEL training for Banking Commission officials, with assistance from the IMF's resident advisor in the Banking Commission, is also underway.

-- The National Competitiveness Council, under the leadership of the Vice President, was created to encourage private investment in sectors that have the greatest potential to generate economic growth.

-- By the end of 2002, a project will be underway to restructure the different institutions in the public sector and reduce duplicative functions by government agencies, eliminate excess jobs and in general terms improve the provision of services by the public sector to guarantee efficiency and efficacy in the assignment of financial resources, public spending and better service to the public. Before beginning this project, measures will be taken by the end of the year to reduce the size of the public sector.

The measures described above clearly demonstrate that the Honduran government is committed to fulfilling its medium and long-term macroeconomic goals by maintaining balanced public finances, creating an environment to achieve high and sustainable economic growth necessary to reduce poverty, improving the efficiency and quality of public spending, widening the coverage and reach of programs to reduce poverty and social spending, eliminating the domestic financing needs of the public sector and maintaining a monetary and exchange rate policy in accord with the requirements of economic growth and competitiveness for the productive sectors.

The Honduran government presented to the IMF a proposal to establish a joint work plan for the rest of 2002:

-- The Honduran government reiterates its commitment to continue coordinating and working with the IMF in preparation for negotiations by October 2002 of a new three-year program beginning in 2003.

-- The Honduran government confirms its decision to define achievable goals within a reasonable timeframe to reduce the public wage bill as a percentage of the GDP.

-- The Honduran government is committed to take additional measures to strengthen tax collection, either through technical assistance by hiring auditing firms and/or reducing public spending, to achieve a non-inflationary and sustainable deficit with foreign resources available at concessional rates.

We hope that the IMF, international donors and other multilateral institutions accompany the Honduran government down this difficult road. We are convinced that maintaining a balanced budget is fundamental to achieving equitable economic growth, reducing inflation and generating resources to combat poverty.

Recognizing that it is important that international bilateral donors and multilateral institutions are informed about Honduras' current fiscal situation and the actions the Honduran government has taken and will take to resolve the fiscal situation, attached are copies of the reformulated 2002 budget, a document reiterating the Honduran government's medium-term fiscal goals and a detailed

analysis of the current fiscal situation.

End informal translation of letter.

¶5. (SBU) Begin Informal Translation of Attachment.

Introduction

A crucially important element for any country is to have a clear vision of its medium and long term goals, along with a strategy for the design and implementation of the means and actions that will allow the country to gradually close the gap between the current situation and the long-term vision.

In this sense, in 2001, the Government of the Republic of Honduras developed the Poverty Reduction Strategy (PRS) which represents in and of itself both a commitment and a shared effort between the Government and Honduran society. At the same time, this strategy will serve as a general framework so that the country promotes investment in projects that are oriented towards the goal of reducing poverty.

In this regard, a concern of the current administration is maintaining a macro-economic environment that promotes a sustainable economic growth. Macroeconomic stability is one of the fundamental pillars of the strategy, without it, the country will not be able to generate the necessary funds to implement the priority investments defined within the framework of the PRS.

We should note that the main premises that make up the PRS are sustained economic growth, with equity, macroeconomic stability, and sustainable government finances.

Within this conceptual framework, we present the medium and long-term vision of the non-financial public sector (NFPS), an analysis of the current situation in order to determine the existing gap between the two situations, and the fiscal policy measures that the current Government will implement to close that gap and provide the optimal fiscal framework to sustain the PRS.

Medium and long-term vision (plan) for the non-financial public sector

To achieve the necessary conditions to reduce poverty, the plan that the non-financial public sector needs to have centers on four primary aspects:

a) Maintain balanced public finances in order to avoid inflationary pressures and reduce market distortions, thus guaranteeing the growth of a more solid private sector.

b) Generate the necessary financial resources to carry out the programs designed to reduce poverty and social costs, as delineated within the Poverty Reduction Strategy.

c) Improve the efficiency and quality of public spending, increasing the extent and reach of the programs designed for social sectors.

d) Reduce the amount of public financing using domestic resources as much as possible to guarantee that the private sector will have funds available to finance its productive activities and generate economic growth and employment.

This plan is based on the principle that the primary generator of economic growth should be the private sector and the role of the public sector should be focused on social activities with the goal of poverty reduction, establishing a regulatory framework for the development of the private sector and maintaining the macro economic stability of the country.

Nevertheless, we need to keep in mind the fact that the non-financial public sector is made up of diverse players which we can group as: central government, social security institutes, government owned companies and municipalities; each one of these should define their own objectives so that they may accomplish the goals set out in the global plan.

Central Government

The objectives of the central government should be:

a. Finance the deficit solely with foreign assistance available at concessional terms to assure the availability of domestic resources to meet the needs of the private sector.

b. Increase savings in the current account to raise the funds required for the execution of infrastructure and social benefits programs.

c. Control the growth of salaries in administrative

positions and functions that have no positive impact on the delivery of services to social sectors. This group has had the most pressing impact on government spending in recent years. In this way coverage of services can be amplified without provoking inequality in public financing.

Social Institutes

The objectives that social institutes should set according to the established plan are:

a. Continue generating a surplus of 1.5 to 2% of GDP

Public Companies

a. Public companies should generate surpluses of 0.5 to 1% of GDP

b. Establish competitive tariffs for services to citizens, using existing tariffs in other countries in the region as an example.

c. Improve and expand service coverage.

d. Control spending growth, especially related to salaries and payrolls.

Municipalities

Taking into consideration that the process of decentralization will put municipalities into a more preponderant role in the country's destiny. Based on the experiences of other countries in similar situations, municipalities should work from a balanced budget in such a way as the total expenditures are entirely financed by the municipalities own income plus transfers received from the central government.

Expected Results

The results expected upon completion of the outlined objectives:

a. Reach a consolidated net deficit for the non-financial public sector of 0.0% GDP.

b. The net deficit of the central government should be no more than 2% of GDP

c. Finance the central government deficit entirely with available concessional foreign funding

d. The rest of the non-financial public sector should generate a surplus equal to 2% of GDP.

e. Reach annual inflation levels of 2 to 3%

f. Generate real economic growth no less than 5% per year
g. Maintain stability in the monetary exchange market, guaranteeing the Lempira maintains its competitiveness.

h. Generate a substantial reduction in extreme poverty, keeping with the goals and indicators as defined in the Poverty Reduction Strategy.

Actual Situation and estimates for 2003-2007

In order to determine the need to take measures aimed at achieving the objectives set out in the plan of the Poverty Reduction Strategy, an analysis of the current situation is presented which shows the different parts

Central Government

At the central government level, we have seen a decrease in income through 2001, falling from 19.4% of GDP in 1999 to 18.2% of GDP in 2001. For this reason, the government presented to Congress the Financial Stabilization and Social Protection law. It is hoped these measures will increase income to the Central Government to 20.2% in 2002. After 2002, income will remain relatively stable with revenues reaching 20.1% of GDP in 2007.

On the expenditure side, there has been marked growth in the last few years, reaching 25.6% of GDP in 2001 and an estimated 27.2% of GDP for 2002.

The main source of spending growth is the public sector wage bill which has grown consistently in the last four years reaching 10.5% of GDP in 2002. Due to this fact and since the projections have been elaborated under the assumption of salary adjustments based solely on inflation, for 2007 we won't have reached sustainable salary and payroll levels related to GDP (less than 9%.)

As a result of these tendencies in income and spending, it

is estimated that the central Government could meet its objectives congruently with the public sector plan presented earlier and with the fundamental principles of the Poverty Reduction Strategy up to 2005, at which time the central Government would generate a savings in their current account equal to 1.3% of GDP and a net deficit of 1.6%.

Additionally, it should be taken into consideration that for the years 2003-2005 the projections indicate that the central government will have to refinance the deficit by emitting bonds (though this is not congruent with the objective of reducing the crowding out of the private sector and maintaining inflation at low levels) or by requesting new external loans.

According to these projections, the country will be counting on money inflows on the order of $230 million yearly, a figure the World Bank has established as adequate to maintain a reasonable level of indebtedness for the country. Therefore, financing this gap by additional external loans could generate problems in the ability to sustain the foreign debt.

Remainder of the non-financial public sector

In the rest of the non-financial public sector we see a definite tendency towards a decline in income, after reaching 14.5% of GDP in 1999 to an estimated 12.3% of GDP in 2007. This behavior stems from the continued deterioration of incomes from the most important public enterprises without any adjustment to the prices of their services.

This factor has been partially compensated by a declining trend in expenditures by public enterprises, principally due to the lack of investment; but after 2002, expenditures are expected to increase considerably due to planned investments in HONDUTEL and SANAA. In spite of being necessary for modernizing and improving customer service this investment had been postponed in previous years.

In terms of surplus, we see that the rest of the non-financial public sector could present a surplus of around 2% of GDP, established as a goal of the PRS, until 2006. This surplus has shown a downward trend since 2000. This trend will continue until 2003, when the trend will reach the point of inflection and turn towards moderate stability.

Overall, the decreases in revenue by the rest of the NFPS will not be compensated by the revenues to the Central Government, resulting in declining revenues for the consolidated NFPS. Simultaneously, the expenses for the rest of the NFPS, as for the Central Government, show a downward trend; but not sufficient to counteract the drop in revenues. The NFPS is expected to be in deficit for 2001-¶2005. By 2005, the NFPS should reach its goal of a balanced financial account. (Chart shows deficit beginning late 2000, dipping and bottoming out in 2001 to 2003 then reducing the deficit to zero in 2005 and then a surplus after that.

Conclusions

From our analysis, it is evident that the measures taken during the course of the current year are insufficient to generate the conditions of fiscal sustainability required to achieve the objectives of the Poverty Reduction Strategy.

Some of the most relevant factors that the Honduran Government face are the salary pressures generated by the Medical Statute and Teachers Statute (Congressional statutes requiring exorbitant salary levels for doctors and teachers). These factors have contributed significantly to the constant increase in spending in the last few years. It is also necessary to strengthen the tributary administration by reducing fiscal evasion and creating a plan for a reversal of the downward trend in income for the rest of the NFPS.

Taking the necessary measures to confront the difficult fiscal situation that faces the country is an undeniable fact, especially if we consider the deviation between the projections presented in this document and the macro-economic framework of the Poverty Reduction Strategy.

Comparative Table of the Deviations
with respect to the PRS
Deficit of the NFPS as a % of GDP

Year	Projections	PRS	Deviation
1999	0.6	1.5	-0.9
2000	0.1	1	-0.9
2001	(2.6)	(0.8)	(1.8)
2002	(2.5)	(0.6)	(1.9)

2003	(2.5)	(1.9)	(0.6)
2004	(1.7)	(0.7)	(1.0)
2005	(0.2)	(0.3)	0.1

Note: Positive numbers represent a surplus and negative number represent a deficit.

Complementary measures in the implementation process

In order to correct the deviations and close the existing gap between the current fiscal situation and the medium-term plan presented, the current Honduran Government has identified additional methods for the short term in the following areas:

Measures for strengthening tax revenue
Reengineering Government Program
Additional revenue enhancement measures

Means of strengthening tax revenue

In this area, the Honduran Government will emphasize the enlargement of the tax base by exchanging information with municipalities, large contributors and Ministries and Decentralized Institutions. Also, the government will ll
conduct prompt audits to detect businesses that are not registered (additionally eliminating the penalties for not registering) and businesses that fail to pay taxes, and to take steps that will instill a new tax-paying culture in the country. The recent initiative of closing businesses that evade paying sales taxes is a clear example of this. Additionally, we will be receiving technical assistance and initiating a program of external audits to complement these measures to combat tax evasion.

As a complement to the actions leading to the expansion of the contributor base, we will be submitting an equitable and modern Income Tax Law to the National Congress for approval, emphasizing tax simplification as well as the transformation from a Sales Tax to a Value Added Tax effective 2004, consistent with the best tax practices worldwide.

Additionally, the DEI (note: Honduran tax authority) will be restructured in order to strengthen the tax administration and make it more efficient. The DEI will be restructured according to type of taxpayer, consolidating administrative functions and clearly defining collection operations for small businesses. To complement this, new automated systems for information exchange and the administration of the taxpayer accounts are being established.

Reengineering Program

The objectives of the government-reengineering program are:

Evaluate the composition of the quality and technical capacity of government personnel to determine a uniform evaluation and position classification system with respective requirements for qualification.

Identify the processes and procedures employed in the performance of duties and provision of services and improvements needed to increase quality and efficiency.

Define and implement plans to reduce and rationalize each agency's funding.

Complete an institutional restructuring that will allow for a reduction in the number of agencies that comprise up up
the Public Sector and modernize their functions.

We have elaborated the terms of reference and budget for the re-engineering project. With the support of the World Bank, we will solicit an international bid in the near future, with progress expected by the end of the year. As a preliminary step, we have identified the necessity to reduce by 21% (equivalent to 5,000 jobs) the number of governmental administrative positions.

Additional revenue measures

In addition, the Government will be designing a set of measures designed to improve tax collection that will be put into effect in January 2003.

Required support

With everything shown here, it can bee seen that Honduras has advanced considerably in its objective to achieve fiscal sustainability and the medium-term plan for the public sector, through the design and implementation of measures for improvement of tax collection, modernizing spending and improving the efficiency and effectiveness of public spending.

It is worth noting that the current Government is aware of the need for a civil service framework law, which is why it maintained a firm position during the negotiations with the teachers. The government expects similar pressures from other unionized groups in the Public Sector will arise (Social Security and HONDUTEL). Facing this, the Honduran Government considers reducing the expectations the other labor groups have in regards to salary increases to be a fundamental step. Similarly, we have initiated the process of drafting a Civil Service Framework Law, for presentation to the National Congress. This law will emphasize compensation systems based on inflation and efficiency.

To reach the medium and long-term plan for public finances and in order to achieve the objectives established in the Poverty Reduction Strategy, the Honduran Government requests the support of its allies and multilateral organizations in the following ways:

¶1. Receive an extension on Paris Club debt deferral until June 2003, at which time we hope to reach the HIPC completion point.

¶2. Allow the traditional relief received from the Paris Club to be used for budgetary relief, as has been done since 1991 when the framework was negotiated in the Paris Club for the first time, and that the debt relief received under the HIPC initiative be used to finance projects in the Poverty Reduction Strategy.

¶3. Include the costs that the government incurs in increasing the coverage of services in the areas of health, education and security as part of the expenses to be financed with HIPC relief funds for a three-year period, after which they will become a part of the normal expenses anticipated by the Government and financed with domestic funds.

¶4. Support the efforts of the Honduran Government to improve its public finances and achieve a three-year agreement with the International Monetary Fund by the end of this year.

End informal translation of attachment.

ALMAGUER